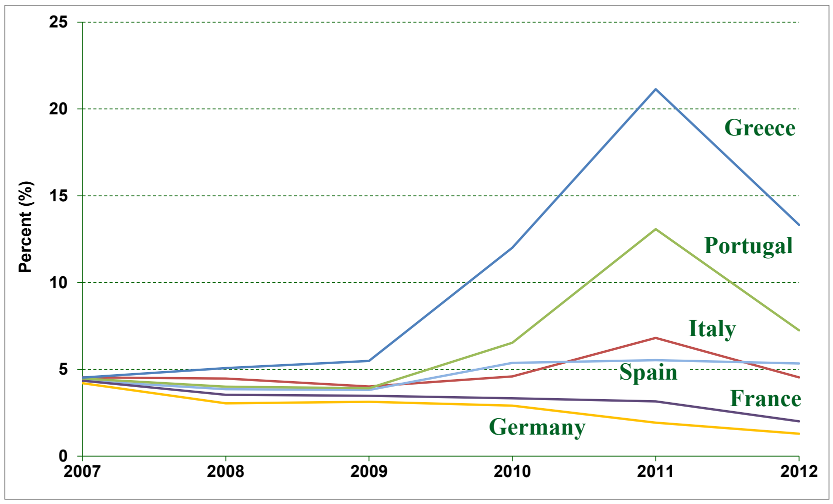
Foraging for Opportunities in Europe While Others Run for the Hills

An Unconventional Approach. Member organizations who have invested with TIFF for some time will be familiar with our investment team's penchant for contrarian thinking. When private equity secondary markets were frothy in 2006, we chose to launch a systematic program of selling selected fund investments. Conversely, when panic was widespread in 2009, we were active buyers of secondary interests in private equity funds. When the real estate sector was out of favor and on its knees, we chose to raise an opportunistic realty fund to exploit the investment opportunities that emerged from the market dislocation. We have declined to stay on board with popular managers that chose to raise larger and larger funds, instead preferring to find the new, up-and-coming managers who are hungrier and more aligned with their investors. We have passed over some of the trendier emerging markets and instead primarily sought out opportunities in the developed markets. Why do we do this? It is not an attempt to be difficult or clever. Rather, it is a simple belief that being contrarian – and right, of course – is one of the best ways to maximize returns for our members. The unconventional decisions listed above –putting capital to work where it was scarce or withdrawing when markets were overheated – have all either paid off already in spades or, where it is too soon to tell, are certainly showing signs of eventually doing so.

Continent in Crisis. It is with this "vintage TIFF" contrarian spirit that we have been turning our attention toward Europe. We do not need to list all of Europe's challenges and ills here. One need only pick up or click on the latest edition of any decent European newspaper to read stories of anemic growth and politicians who cannot seem to compromise to solve problems once and for all, choosing instead to take only the most minimal decisions in order to buy a few months of breathing room. Americans aren't the only ones experiencing the frustrations of this sort of behavior. In fact, Europe's politicians know what needs to be done to achieve long-term economic and financial stability, despite appearances that are often to the contrary. As they are politicians and not technocrats, Europe's leaders tend to pander to their electorates rather than ponder ways to craft bold and difficult, but often necessary, solutions. Indeed, Prime Minister Jean-Claude Juncker of Luxemburg, in a moment of great candor, once said, "We all know what to do; we just don't know how to get re-elected once we've done it." So while the path ahead may be bumpy and full of unfortunate compromises, few now

Long-Term Government Bond Yields, 2007-2012



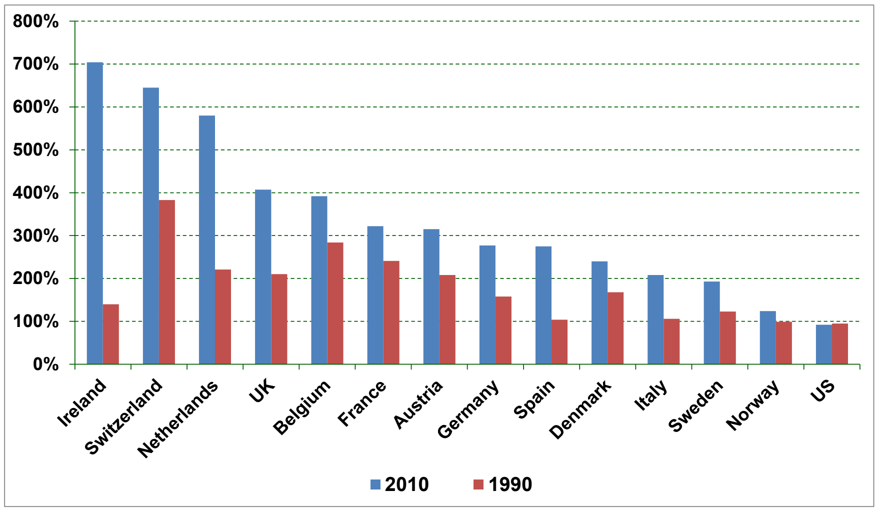
Source: Eurostat.

believe Europe won't achieve a basic measure of stability in the end. Indeed, the market has long since priced out the possibility of a "Grexit" (the exit of Greece from the euro), and bond yields have come back down from their 2011 peak (see above). Despite this, many investors – including some we know and for whom we have great respect – have declared that they will allocate no more money in Europe "until things settle." While we're not exactly sure what they're waiting for, we are relatively certain that under a wait-and-see strategy, there will be some babies thrown out with the bathwater.

Rome Calling. As a result of these blanket write-offs of entire countries or continents, we believe that opportunities to find jewels in out-of-favor geographies are increasing. For example, there is a particular mid-market buyout manager in TIFF's portfolio that has performed incredibly well. On the team's first exit, they multiplied the principal invested by 4 and returned 60% of their entire fund. The second exit is expected in short order, and current negotiations indicate it will be an approximately 3x return. These returns are excellent on both an absolute basis and relative to public equity benchmarks. Yet this manager is now struggling to raise a follow-on fund and has repeatedly delayed a first closing. How could this be, you ask? Their only sin is that they are Italian and invest in Italy, that "crazy" country that delivered 25% of the vote to a comedian-run protest party in their February elections. The GP is not laughing as the vast bulk of the money for their first fund came from US organizations. Those same groups are now explaining that they can no longer propose an Italian opportunity to their investment committees. The euro zone, and in particular Italy, are simply off the table, they say. The upshot is that TIFF now has the opportunity to come in as both a primary investor and a co-investment partner – and to fashion terms better suited to us – with a team that is proven and highly motivated to succeed. We do understand the recent elections are unsettling and, moreover, that getting a "bargain" price on something that is worthless is in fact no bargain. However, we see real value in this investment, and are very interested in partnering with this team in particular and in gaining exposure to Italy in general. While Italy is known globally for its contributions to food and fashion, it is perhaps less well known for its large industrial exporters such as Fiat, Pirelli, and the Anglo-Italian helicopter maker Agusta Westland, which is owned by Finmeccanica. It also has a richly populated mid-market, with more than 19,000 companies in a range of industries, according to the European Commission. Italy is the eighth largest economy in the world (World Bank ranking by 2011 GDP) and is a significant exporter, particularly to the fast-growing economies of Asia and Latin America. Partnering with a manager who not only knows the market but also has a strong track record – especially when capital is flowing out of the market, making it a less competitive environment – is smart investing, in our opinion. We would rather commit money to Italy – judiciously, and with a team we know well – than rush to the latest overheated locale already crowded with LPs (read: expensive). To be sure, this strategy doesn't apply to the entire spectrum of challenged European economies. While Italy is intriguing and while we may hunt for a Spanish manager as well, Portugal and Greece hold less interest for us because their economies are more challenging.

Market Cycle Disconnect. Additionally, because Europe is at a different stage in the economic cycle, the sorts of opportunities that are ripe in Europe have already come and gone in the US. As members know, TIFF compares every dollar invested in one manager to our competing options globally. Staff in our London office constantly compare notes with our US-based colleagues, and often meet with US managers during our travels. On a recent trip, those of us based in the UK were struck by the fact that our US private realty managers were saying that the distress opportunity is over. This stands in marked contrast to the unfolding opportunity in Europe. European banks were very slow to take writedowns and sell distressed assets. Indeed, the International Monetary Fund estimates that European banks need to sell as much as $4.3 trillion in assets by the end of 2013 to improve their balance sheets and to "rightsize" them for GDP (see Banking System Assets chart above). Regardless of which very large number you believe will actually come to market, it is important to acknowledge that European banks are finally able to shed troubled assets because they have the equity base to withstand the necessary write-offs. As a result, TIFF's European real estate managers have seen their deal pipelines expand with a significant supply of REO (real estate owned by the banks) and assets being sold out of administration (bankruptcy, in US parlance). The same is true for one of TIFF's European distressed debt managers. In a recent meeting, this manager noted the decoupling of US and European default rates on leveraged loans over the past two years, with the European default rate now

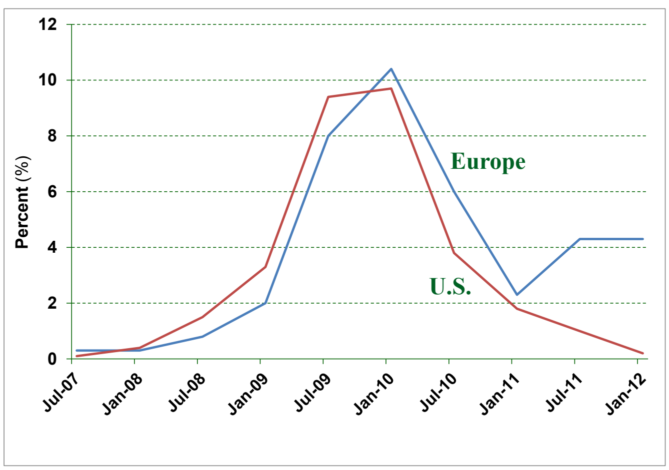
Banking System Assets to GDP, 1990 vs. 2010



Source: Barclays Global Credit Markets, Insight and Opportunities, 19-Oct-2011.

significantly greater than the US rate (see Leveraged Loan graph below). When pressed to shed further light on this phenomenon, they explained that in the US, the default rate is lower because an issuer has multiple escape routes when there is a problem: 1) the US has a larger high yield bond market; 2) though growth has been anemic in the US, a policy of fiscal stimulus rather than of austerity has allowed some companies to "grow into" their capital structures; and 3) new leveraged loans are still being issued in the US (as compared to European banks, whose lending has contracted if not dried up completely). More importantly, our distressed debt manager noted that when US issuers do restructure, they do it right the first time, whereas European issuers often take the long, protracted path of death by a thousand paper cuts. This inefficiency yields opportunity for them, though, so they are not complaining!

Leveraged Loan Default Rates, U.S. vs. Europe, 2007-2012



Source: Babson Capital via S&P Leveraged Comentary and Data. Europe is defined as the euro zone countries: Belgium, Cyprus, Germany, Estonia, Ireland, Greece, Spain, France, Italy, Luxembourg, Malta, Netherlands, Austria, Portugal, Slovenia, Slovakia and Finland.

Apples to Oranges. Opportunities also arise for structural reasons regardless of the market cycle: investing in Europe can be complicated. However, complexity and opacity can turn into returns given the right investment team. As one debt issuer recently explained, US term sheets are presented in an "apples to apples" manner, making it easy to pick the best. In Europe, because everything is bespoke, winning the deal requires patience in understanding the motivations of the parties around the table and the ability to speak their language – literally and figuratively. Because Europe is not a uniform market despite the European Commission's ongoing single-market efforts, there are still inefficiencies to be exploited – ones that can often translate into increased returns to patient, knowledgeable investors.

The Nature of the Game. Even the nature of the private equity industry in Europe creates interesting attractions. Compared to the US, Europe's private equity market is still nascent in some respects and therefore less developed. The natural evolution we have seen is that generalist managers enter markets first, followed by more specialized managers that focus on a smaller region and/or industry. As more specialist firms are born, they can often source deals with more ingenuity and thus outwit the thinly spread generalists. One area in which we see this phenomenon playing out now is resources. While some of TIFF's most successful managers have been US-based resources managers, we have so far been hard-pressed to find similar managers outside the US. TIFF is therefore excited to be researching a few resource managers based in Europe that we believe have the potential to make excellent additions to our manager roster.

We are spending considerable time and effort in European markets as we search for superior investment opportunities. Our contrarian spirit demands it. The outcome is never guaranteed, of course, but the process has been interesting and will hopefully bear fruit. We're not sure we can convince all of the anti-euro naysayers. But frankly, we like it that way. The more investors who run for the hills, the greater the opportunity left for the brave! ■

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